Alberta Tax Review Committee

Phase 1

Report and Recommendations on Knowledge-based Industries

May 1998

1998 Tax Review Committee

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Alberta Tax Review Committee

Honourable Stockwell Day
Provincial Treasurer

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Alberta Tax Review Committee

Honourable Stockwell Day
Provincial Treasurer

Dear Mr. Day:

Members of the Alberta Tax Review Committee are pleased to submit to you our report and recommendations for phase 1 of the Committee's mandate.

In this first phase, our work concentrated on tax issues specifically related to the knowledge-based industries. The Committee currently believes that the best overall tax policy for Alberta is to provide a low rate, broad based tax environment. If there are exceptions to this overall approach, those exceptions should be clearly justified.

In considering issues related to R&D activities in the province, the Committee's view is that an exception to the overall policy of low rate, broad based taxes can be justified. R&D activity is not industry-specific and applies to a broad range of industries and businesses in the province. There is evidence to suggest that Alberta may be at a disadvantage in attracting and retaining R&D investment because of the number of provinces that have moved into providing direct tax incentives for R&D activities. For this reason, the Committee recommends that the province consider introducing a modest tax credit which parallels the federal program. The Committee sees this as a transitional measure and strongly recommends that performance measures and a sunset clause be built in.

On the specific issue of targeted tax incentives for the film industry, the Committee does not support tax incentives for particular industries. We understand the current problems the film industry in Alberta faces as most other provinces move in the direction of tax incentives. We have suggested that the public and private sectors work together to research other innovative approaches that could be used to assist knowledge-based industries in Alberta, including the film industry.

Finally, the Committee reviewed issues related to access to venture capital and concluded that the province should not introduce tax incentives to encourage investment in venture capital funds.

The Committee views this phase 1 report as an interim report. Recommendations coming from the second phase of the report will undoubtedly have an impact on Alberta's competitive advantage in all sectors of the economy, including the knowledge-based industries.

Jack Donald, Co-Chair

Gary G. Campbell, Q.C., Co-Chair

Introduction

Alberta's Tax Review Committee was established by the Provincial Treasurer in February 1998. The task of the Committee is to examine specific aspects of Alberta's tax structure and to make recommendations to the Provincial Treasurer. Working closely with the Taxation and Financing Committee of the Alberta Economic Development Authority, the Committee was asked to evaluate options for the province's personal and corporate income tax system, including, but not limited to, the role and mechanisms of government for knowledge-based industry financing.

The first phase of the Committee's work focuses on government's role in and mechanisms for financing knowledge-based industries in Alberta. Knowledge-based industries include research and development activity and motion picture film and video production.

In this first phase, the Committee was asked to explore whether Alberta should:

- Implement specific tax credits for the knowledge-based industry
- Implement other mechanisms for promoting investment in the knowledge-based industries
- Enhance the existing policy of low rates levied on a non-selective, broad base.

In assessing the issues and options, members of the Committee met with a number of individuals and organizations, reviewed presentations, reports and studies, and considered a variety of options for addressing the tax-related issues specific to the knowledge-based industries. In total, over 90 submissions and letters were received. Given the short timeframe for phase 1, the Committee did not hold public consultations but had informal discussions with various stakeholders including key representatives of the knowledge-based industries. The Committee also held discussions with financial market experts on the issue of access to capital and the need for early stage and seed capital in Alberta.

This report summarizes the issues involved and provides the Committee's recommendations for tax policy changes for the knowledge-based industry.

The Committee views this phase 1 report as an interim report. In phase 2, the Committee will address personal income tax issues and make recommendations on moving to a more flexible and effective system. The Committee will consider whether Alberta should take advantage of greater flexibility available under the Alberta/federal tax collection arrangements to redesign the province's personal income tax system. Phase 2 of the Committee's work should be complete by September 30.

In the coming months, the Committee will address a number of issues with respect to Alberta's personal income tax system and its impact on the corporate income tax system. Because Alberta's personal income tax system and the ability to offer a low-tax environment have an impact on Alberta's competitive position, the recommendations in phase 2 will undoubtedly affect Alberta's knowledge-based industries and Alberta's ability to attract those industries and skilled employees to our province. Because the recommendations from phase 2 may affect the recommendations in phase 1, the Committee views this as an interim report.

What are the issues?

Across Canada and around the world, there is a growing recognition that knowledge-based industries hold a tremendous potential for future economic growth. While Alberta's past growth has primarily been driven by our natural resource wealth, in the future, knowledge and our ability to convert ideas and research into commercially viable enterprises will be essential to our ability to compete in a global marketplace.

Knowledge-based industries have been defined by the Royal Bank as young or emerging market sectors that are heavily research and development oriented, have high growth potential and are primarily exporters. The sectors include: information technology, life sciences and health care, media and entertainment, advanced materials and manufacturing.

From the Committee's review of related reports and submissions, the following are the key issues involved.

1. *Advantages of selective tax incentives vs. an across the board, low tax environment*

Central to the debate is an assessment of whether Alberta is better off maintaining or enhancing the current policy of low rate, broad based taxes, or moving into selective tax incentives for knowledge-based industries. This assessment should take into account the interprovincial and international tax environment and spillover benefits of investments in knowledge-based industries.

2. *An un-level playing field*

Alberta's tax policy has been focused on maintaining low taxes for all. Other provinces have moved into selective tax incentives for knowledge-based industries including research and development and the film industry. The existence of tax incentives in other provinces can create an un-level playing field among the provinces.

Some have argued that this puts Alberta at a disadvantage in attracting investment and activity in knowledge-based industries. They suggest that Alberta is losing out in venture capital invested in knowledge-based industries and the only way to correct the problem is for Alberta also to get into the tax incentive business. In the film industry in particular, information presented to the Committee shows a considerable drop in film activity in the province since other provinces began to provide specific tax credits and Alberta stopped providing direct support to the film industry.

3. *Access to patient venture capital*

In the early stages of knowledge-based industry businesses or ventures, the primary "assets" are the intellectual property and potential of their people. It takes considerable time, research and development work to bring ideas to the stage of becoming commercially viable products. This creates a need for patient early-stage working capital financing. Representatives of

knowledge-based industries suggest that there is a problem in accessing this type of venture capital and that Alberta lags behind other provinces in total venture capital invested in Canada.

4. *Mobility of knowledge-based industries*

The primary product of knowledge-based industries is intellectual property – the ideas of people involved in the industry. The industries and the people they employ are readily transportable to anywhere in the country or anywhere around the world.

5. *Assessment of long-term costs*

The introduction of any specific tax incentives or credits has a cost to government and the economy. These costs may be outweighed by an increase in activity, an increase in jobs, or a long term increase in personal and corporate taxes once industries become viable. It is essential that the costs of any changes in tax policy be assessed carefully.

What alternatives have been considered?

In addition to identifying and reviewing the issues involved, the Committee also reviewed a number of alternatives for addressing the issues.

Governments across North America and elsewhere have recognized access to capital as an issue and adopted various measures to encourage investment in the areas identified as "gaps." There also are other mechanisms employed to encourage firms to conduct R&D, increase R&D spending, and to attract firms in the knowledge-based industry. Every measure has a cost in direct government expenditure or forgone tax revenue. Some examples are:

➢ ***Direct financial involvement***

- Grants – direct government funding to a particular business or industry
- Equity participation – government becomes a shareholder in a business or industry venture

- Loans or loan guarantees – government lends money to a particular venture or guarantees a loan made by a third party financial institution
- Each of these approaches is more visible than tax measures and may provide a return on the investment to government, but involves government in picking particular industries or businesses to support.

➢ ***Tax credits to create investment pools***

- Labour Sponsored Venture Capital Corporations (LSVCCs) – individuals receive tax credits for investments in professionally managed investment companies
- Small Business Equity Corporations (SBECs) – private companies earn tax credits for qualifying investments

➢ ***Tax incentives to encourage direct equity investment***

- Preferential capital gains/capital loss treatment – to benefit individuals making equity investments
- Flow-through shares – to allow losses or write-offs to flow through to the individual investor
- Tax credits on equity investments – to directly stimulate equity investment by providing individual tax credits
- Royalty holidays – to allow smaller or early phase resource industries to pay lower royalties to the province

➢ ***Government funded investment agencies***

- Government can set up agencies or research organizations to partner with the private sector in pursuing projects. This creates a stable source of funding, including private sector capital.
- Examples include -
    - Business Development Bank of Canada, Western Diversification, Atlantic Canada Opportunity Agency, Alberta Oil Sands Technology and Research Authority, Alberta Opportunity Company, Agriculture Value-added Corporation, Alberta Research Council.

- ***Endowment funds***

  - Government can establish a pool of capital which generates a steady income stream. This income is distributed by industry or academic peers. Endowment funds require a substantial pool of capital to generate enough income to fund grants to industries and to maintain their value against inflation.

- ***Education and matching services***

  - Education facilities and government departments can provide management and business planning information to entrepreneurs and investors specifically related to knowledge-based industry issues and challenges.
  - Examples include -
    - Investment Matching Services of Alberta – to facilitate matching projects with potential investors
    - Business counseling and management training programs

- ***Regulation***

  - Government can use regulation to encourage particular industries. Examples include the Canadian content requirements for television and radio or regulations giving first preference to products developed within the province.

In addition to these general alternatives, the Committee heard specific proposals from a number of different organizations.

A joint presentation from the Alberta Science and Research Authority and the Alberta Motion Picture Industries Association recommended a three-stage package of fiscal measures.

- Stage one – a provincial tax credit for innovative activity. This would provide a 30% provincial tax credit to corporations involved in research and experimental development activities and film and video production. The credit would be applied to wage, salary and contract expenditures. The credit would parallel the

federal tax program for Scientific Research and Experimental Development and Revenue Canada regulations for film and video production. To reduce the cost of the tax credit, the maximum tax credit would be capped at $2 million a year.

- Stage two – an Alberta Venture Capital Tax Credit. This would be designed to stimulate the creation of private venture capital pools for Alberta companies engaged in innovative activities. It would parallel the federal Labour Sponsored Venture Capital Corporation program. Individual investors would be eligible for a 15% federal tax credit. They also would be eligible for a 20% provincial tax credit on investment of up to $5000 in an Alberta-approved fund. Investors also would receive an RRSP deduction for their investments.

- Stage three – an Early Stage Private Investor Tax Credit. The objective of this credit would be to encourage and reward investors in early-stage companies that ultimately become successful. Because this proposal was in the concept stage, no further details on specific parameters were provided.

The two organizations recommend that stages one and two be implemented immediately. In their view, the result of these actions on the film side would be to increase production levels to $300 million annually by 2005. On the R&D side, their submission argued that R&D tax credits pay for themselves through increased taxes resulting from increased productivity, jobs and salaries.

At the Alberta Growth Summit held in September 1997, the Business and Industry Sector suggested that Alberta should introduce tax incentives "only if inter-jurisdictional tax inequities create a competitive disadvantage for Alberta businesses." Their report cited tax treatment for R&D and the film industry as possible examples where Alberta businesses are at a competitive disadvantage. They also made two recommendations for establishing Alberta-based growth funds to improve access to capital – an Alberta Advantage Technology Fund and an Alberta Advantage Growth Fund.

Discussion of the issues and alternatives

In preparing its recommendations, the Committee discussed the issues involved and assessed the pros and cons of various options.

Targeted tax incentives vs. broad-based low-rate taxes

Of particular concern to the Committee was the central issue of weighing the benefits of implementing specific tax incentives or other mechanisms for promoting investment in the knowledge-based industry as opposed to maintaining and reinforcing the existing policy of low rate, broad based taxes.

If Alberta moved ahead with a package of tax incentives and new venture pools for knowledge-based industries, would that achieve the outcomes we want – sustainable knowledge-based industries, greater investment, and more highly skilled jobs for Albertans? That's the key question.

On the one hand, the Committee understands that competitive tax policies are a reality and have an influence on investment and business location decisions. Other provinces have provided targeted tax incentives and Alberta stands out as an exception to this trend. A summary of selected provincial corporate tax incentives is included in the appendix. That summary shows that six out of ten provinces provide tax incentives for research and development and eight out of ten provinces provide targeted tax credits for the film industry. Some people argue that since other governments interfere in the market place, the Alberta government must provide competitive tax incentives to maintain balance in the mix of economic activity in the province.

There is evidence to suggest that Alberta may be falling behind other provinces in terms of R&D investment. Although Alberta has been third in terms of R&D expenditures per capita for the last ten years, the growth of R&D expenditures has been slightly lagging the Canadian average. In terms of taxes, the size of Alberta's tax advantage for R&D is not sufficient to match the special tax advantage provided by six provinces with a provincial R&D tax credit. At the same time, businesses and industries in Alberta benefit

from lower overall taxes, no general capital tax or payroll tax, and no provincial sales tax.

In terms of venture capital, it is difficult to determine whether the availability of venture capital is a problem. Information for the last five years shows that Alberta firms have received relatively less venture capital than other firms in Canada. However, recent data shows that this trend may be changing.

The film industry in Alberta faces a particular challenge. Information presented to the Committee suggests that the termination of provincial funding compounded by the availability of targeted tax incentives offered to the film industry by other provinces, has led to a dramatic downturn in the amount of film activity and new projects in Alberta. The argument presented is that unless Alberta also gets into the business of tax incentives for the film industry, we will risk losing this industry almost completely. This could happen at a time when the film and entertainment industry is growing across Canada and there is an increasing convergence of related industries such as television, telephone, cable services, publishing and the Internet. If Alberta loses the pool of talent and activity, some argue that it will be difficult to re-build the industry in future and other related industries could suffer as a result.

The Committee also heard arguments that implementing specific tax preferences can offset a deficiency in the market that results from the "spillover" of benefits of investment in R&D. There is a disincentive for firms to engage in R&D because they do not capture the full advantage of R&D, but see it "spill over" for the benefit of all, including competitors. This makes businesses engaged in R&D likely to engage in less R&D activity unless government provides support to offset the spillover benefit to other businesses.

In contrast to those who favour targeted tax incentives, many businesses argue that the best advantage for Alberta comes from a low rate, broad based tax environment. This approach provides a similar benefit to all businesses rather than a specific benefit to specific industries. Some argue that Canada already offers overly generous tax incentives which could result in a misallocation of resources. There also is a concern that providing tax incentives to

one particular sector may open the doors to similar requests from other industries as well. Many suggest that government should stay out of the business of interfering in the marketplace and stick with a policy of overall low taxes for all. Some also suggest that providing targeted tax incentives slightly lessens the ability of government to lower taxes for all Alberta businesses.

There also is some debate over the role tax incentives play in stimulating investment and affecting location decisions by businesses. An evaluation of the federal system of income tax incentives for Scientific Research and Experimental Development (SR&ED) concludes that for each dollar in taxes foregone by the federal government, $1.38 extra was spent on SR&ED. On the other hand, the Tax Issue Team report to the Growth Summit notes that taxes are not the only or even the most important factor in business location decisions. Other important considerations include the cost of labour, transportation costs, average length of work week and quality of life.

The Conference Board of Canada report suggests that tax levels, grants and other fiscal incentives are not of significant importance in location decisions by high-tech firms. The availability of a skilled workforce and quality of life are the key factors influencing their decisions. Governments have a role to play in encouraging clusters of these firms to locate in their area, but the firms preferred governments to limit their involvement to quality of life issues and providing an environment that's conducive to low costs.

The Committee also carefully reviewed the conclusions of the Report of the Technical Committee on Business Taxation chaired by Jack M. Mintz and released by the federal government early in April 1998. The basic thrust of the Mintz report is on:

- Providing lower corporate income tax rates and a broader tax base
- Making certain profit-insensitive taxes fall more heavily on those who derive related benefits from public programs and contribute to costs for Canadians
- Reducing compliance costs and improving enforcement and
- Facilitating coordination and disentanglement of federal-provincial corporate tax policies.

On specific issues related to R&D tax credits, the report concludes that Canada's tax treatment of R&D spending is generous by international standards, but we lag behind other major nations in relative R&D spending. The Mintz Committee also noted that the federal SR&ED tax credit does provide valuable support to R&D initiatives, and the refundable portion for "smaller firms" helps to address the capital access issue. But the Mintz Committee also noted that the federal credit tends to focus on the scientific discovery of innovations instead of the adoption of the idea, which ultimately is what benefits a knowledge-based economy. The Mintz Committee recommended lowering the size of the credit and lowering corporate income tax rates. Currently, corporate income tax rates are higher than those of our global competitors and this discourages adoption of the results of R&D in Canada and the development of R&D clusters. The Mintz report also noted that the relative level of personal income tax rates makes it costly for Canadian firms to attract and retain skilled labour.

Un-level playing field

This issue is closely related to the central question of whether specific tax incentives or broad based low rate taxes is the best policy for Alberta.

Those who support tax incentives argue that Alberta will be unable to compete in attracting and maintaining knowledge-based industries if we do not move into tax credits similar to other provinces. On the other hand, some suggest that this approach simply leads to "a race to the bottom" as provinces try to outdo each other in offering the most attractive package of tax incentives. Some suggested that Alberta should take a different approach – maintaining the lowest across the board taxes and encouraging other provinces to get out of the tax incentive business. We also heard suggestions that once Alberta opens the door to tax incentives for one industry, we risk opening the doors to other requests for tax incentives for a wide range of industries that could argue they, too, need tax incentives in order to compete.

Access to patient venture capital

The Committee heard specific concerns about the lack of venture capital, particularly from investors who are willing to wait a considerable period of time before they see a return on their investment for early stage development. On the other hand, the Committee also heard that the problem is less with the availability of investment capital and more with the lack of commercially viable initiatives. Some argued that the problem isn't a shortage of venture capital – there are many pools of funds available and investors interested in R&D investments. In some cases, a problem lies with the lack of management skills and difficulty some of these businesses have in developing a viable business plan. In others, it's simply a matter of connecting the person with the ideas with the right venture capitalists. The Committee also heard concerns about regulations that create a bottleneck at the Alberta Stock Exchange.

The Committee reviewed several of the vehicles that had been used in other provinces and in Alberta to establish pools of venture capital.

The Committee also reviewed the option of labour sponsored venture capital corporations (LSVCCs) and other publicly-funded venture capital funds. With LSVCCs, individual taxpayers receive a tax credit against their federal and provincial income tax for investments in eligible venture capital corporations. All provinces except for Newfoundland, Prince Edward Island and Alberta have adopted some form of LSVCCs.

Legislation varies from province to province, but generally the objectives of LSVCCs are to create jobs and to strengthen economies by increasing the availability of equity capital to support small and medium sized business opportunities. Another objective is to build a liaison between business and labour. LSVCCs must be sponsored by a labour organization or professional organization. The specific purposes of LSVCCs in various provinces range from concentrating investment in health technology to broad objectives of creating superior long-term value for shareholders and contributing to the prosperity of the Canadian economy.

LSVCCs have generated substantial controversy. Concerns most often cited include a slow pace of investment and extensive tax benefits. In the early years, LSVCCs were successful in raising investment funds but had more difficulty in placing the funds in business ventures. The performance of individual funds in different provinces varies considerably. At best, their success has not been proven to date. While the investment community would benefit from the marketing of LSVCCs, the Investment Dealers Association recommended against establishing them in Alberta. Also the significant administrative costs for government and for the LSVCCs was a concern.

In terms of publicly-funded venture capital funds, Alberta's experience has not been positive. Vencap was established by the Alberta government with funding of $240 million and the objective of investing in venture capital. Vencap experienced many of the same problems as LSVCCs – a lack of good investments and a reluctance to take risks. As a result, a relatively small percentage of Vencap's equity ended up in new Alberta ventures. The Alberta Opportunity Company faced similar problems in operating a program to support investments in start-up knowledge-based industries.

From 1984 to 1986, Alberta had a Small Business Equity Corporations program. Its purpose was to stimulate the formation of equity capital pools and to invest in small business startups, expansion or debt restructuring. A grant or tax credit was provided to entities that created a Small Business Equity Corporation that invested in eligible target businesses. The program was cancelled in 1986 and several problems were noted including the high overall cost per job created.

Mobility

The Committee heard concerns that Alberta could risk losing many of its talented and highly educated people if specific actions were not taken to improve Alberta's ability to attract investment in knowledge-based industries. Unless there is a pool of resources here in Alberta, people will have to move to where the jobs and industries are located.

The mobility of the workforce and investment in knowledge-based industries suggests that low personal income tax rates could be an

incentive for attracting investment and people in the knowledge-based industries. If people are highly mobile, and if the primary resource of knowledge-based industries lies in its people, then personal income tax rates should have an influence on location and investment decisions.

Long-term costs

Tax credits for investment in R&D or the film industry could result in a net economic benefit to the province if they result in increased economic activity. However, tax incentives or credits of any kind carry an economic cost and are a cost to government. On the economic side, tax incentives may result in investment being diverted away from industries that may have been a better investment for the economy as a whole. The cost to government could be offset if the incentives generate sufficient increased personal and corporate tax revenues. On the other hand, tax incentives may merely generate activity and not result in an increase in overall tax revenues, particularly if the products are commercialized in other provinces or countries. If products are developed in one jurisdiction that provides tax incentives and then commercialized elsewhere, the primary benefits of commercializing the product will be received in other jurisdictions. In this case, tax incentives can be costly and may run counter to the objective of lowering the tax burden generally. Some have argued that the major problem lies not in the investment phase but in commercializing or exploiting the products of R&D activity. Tax incentives also complicate the tax system and increase administration costs to government and compliance costs to business.

Committee's views and recommendations

As a starting point, Committee members believe that the best tax policy for Alberta is to provide a low rate, broad based tax environment. This approach benefits all business and industry and avoids having government play a direct role in interfering in the marketplace.

If there are any exceptions to the overall approach to a low rate, broad based tax policy, those exceptions have to be clearly justified. The Committee also believes that any selective tax policies should be tied

to achievement of certain performance targets and that a sunset clause should be included so these selective measures do not become a permanent feature of Alberta's tax policy.

At the same time, the Committee understands both the importance of knowledge-based industries to Alberta's future and the need to maintain a competitive advantage to attract investment and industry to the province.

The Committee members recognize the impact of other provinces' tax policies on Alberta's tax competitiveness for knowledge-based industries. Several members commented that they would prefer to see other provinces get out of the business of providing specific tax incentives rather than have Alberta "join the club". Rather than competing with other provinces on tax incentives, we should consider the competitiveness of Alberta's overall tax environment with other jurisdictions around the world. We also should assess the impact of tax policy not only in terms of whether it generates activity, but more importantly, whether it successfully encourages exploitation and commercialization of that activity.

In that context, the Committee recommends that:

1. ***On a transitional basis, the province should implement a 10% tax credit for R&D, paralleling the federal program. The credit should be refundable within the limits set by the federal credit and contain a sunset clause with performance targets.***

   While in principle, the Committee is reluctant to recommend tax credits for R&D, we have been persuaded by the arguments that suggest these tax incentives are important for Alberta to be able to attract and retain R&D investment in the short run. They also would apply to a broad range of industries and businesses involved in R&D activity, particularly the knowledge-based industries. Providing an R&D tax credit also would help create a positive perception of Alberta's market for R&D investment.

   We see this as a transitional measure until such time as the province is able to lower overall taxes. The Committee also feels

strongly that these tax credits should be tied to specific performance targets and include a sunset provision so they do not become a permanent feature of Alberta's tax policy.

In preparing this recommendation, the Committee considered whether:

- The tax credits should be available only to small and medium sized businesses.

  The Committee considered whether the tax incentives should be limited to small businesses only, based on the argument that large firms already invest in R&D and do not need the same tax incentives as smaller companies. On the other hand, we heard that there is a significant advantage to attracting large R&D businesses to Alberta. These major companies provide a significant base of R&D activity, spin-off benefits and opportunities for other smaller companies, and a significant economic benefit to the province. Therefore, the Committee agreed that the tax credits should not be limited to small and medium sized companies. Any business that does R&D in Alberta would be eligible for the tax credit.

- The tax credits should apply to all funds spent on R&D or only to incremental dollars.

  The argument in support of applying the tax credit to only incremental dollars is that it becomes an incentive for additional R&D activity rather than simply providing a tax break for activity already taking place. On the other hand, the Committee heard concerns about administrative complexities and the problems of distinguishing "new" from "old" spending on R&D. Therefore, the Committee's view is that the credit should apply to all spending on R&D in the province.

  At the same time, we acknowledge that some other jurisdictions have implemented tax incentives that focus only on incremental investment. Those options may have merit and should be studied further.

- The credit should be refundable or non-refundable, or a combination of both.

  A non-refundable tax credit is one where the credit simply acts to reduce the taxes owing. A refundable credit, however, not only reduces taxes owing but also pays out any excess of the credit to the taxfiler. Refundable tax credits are available to beneficiaries even if they pay no taxes.

  The federal credit provides a refundable credit to Canadian Controlled Private Corporations (CCPCs) up to a certain amount of eligible expenditures, and a non-refundable credit to other firms and to CCPC expenditures above the cap. Refundability helps to address the access to capital issue for small, start-up firms. These firms are rarely in a taxable position and would therefore not receive any immediate benefit if the credit was non-refundable. Targeting the refundable portion also serves to cap the government's expenses and to prevent bigger or non-Canadian controlled companies which spend large amounts on R&D already, from receiving large cash payments from taxpayers. These larger companies are able to reduce their tax liabilities using the non-refundable credit.

  The Committee's view is that this approach is appropriate given the access to capital issue. The Committee therefore recommends a combination of both refundable and non-refundable credits parallel to the federal system. Like the federal program, the refundable portion would be capped at $2 million of eligible R&D expenses and would be available only to small CCPCs. The non-refundable portion would not be capped and would be available to large corporations. On balance, the Committee felt that capping the non-refundable portion could lead to contracting out abuses and that the spin off benefits of large corporations' R&D investments were a material factor.

The following table provides an initial estimate of the costs of implementing an R&D tax credit as proposed in this recommendation. These are estimates of the initial costs to

government and do not include an estimate of the benefits which may result from the tax credits.

Cost of R&D Tax Credits

	1999	2000
10 % refundable credit limited to small CCPCs, capped	$10 million	$11 million
10% non- refundable credit for large corporations	$43 million	$45 million
Total	$53 million	$56 million
Note: This includes the straight cost to government and does not include any estimate of the benefits or an assessment of the economic cost.		

2. Government should not introduce industry specific tax credits.

As a basic principle, the Committee does not believe that the province should get into the business of industry-specific tax incentive programs. R&D tax incentives are broad-based and apply to a wide sector of Alberta businesses and industries who undertake R&D. Industry specific tax credits benefit only that one industry. They get government in the business of selecting particular industries to support.

The Committee understands that, if government chooses to implement this recommendation, it could have a negative impact on Alberta's film industry. The industry faces the unique challenge of having to compete with other provinces that offer targeted tax incentives.

The Committee understands that there is an un-level playing field across Canada in terms of tax treatment for the film industry.

However, we are reluctant to enter the "race to the bottom" – a competition with other provinces to see who can offer the biggest and best incentive package. We also are reluctant to recommend that government create an un-level playing field in Alberta by providing industry-specific tax credits to certain industries and not others.

At the same time, we understand the lack of tax incentives in Alberta could have a dramatic impact on the future of the film industry in Alberta. If Alberta wants to maintain or expand the film industry, the province will need to consider what actions could be taken to promote this industry and improve Alberta's ability to compete with other provinces. As a matter of principle, we disagree with the concept of industry-specific tax incentives.

3. *The province should not introduce any type of provincial tax incentives for investment in venture capital funds, including Labour Sponsored Venture Capital Corporations.*

The Committee reviewed various Labour Sponsored Venture Capital Corporations funds in other provinces and heard views from the Investment Dealers Association of Canada, KPMG, and the Alberta Science and Research Authority on these funds.

As noted previously, LSVCCs are controversial and have had varying degrees of success or failure. Most of these funds have not been able to invest more than half the money they received, and in most cases, they do not address the need or gap for seed and early stage capital in emerging high tech firms. All similar programs in Alberta such as Vencap, Small Business Equity Corporations, and the Alberta Stock Savings Plan, have been costly failures for the Alberta government.

In the Committee's view, the refundable nature of the R&D tax credit proposed under recommendation 1 will help address the problem of access to capital since it will provide additional funds for R&D investment.

4. ***There should be ongoing research by both the public and private sectors into innovative and creative incentives, including a better delivery system for knowledge-based industries.***

While the Committee recognizes the value of knowledge-based industries and the need to ensure that the Alberta Advantage applies fully to these industries, the Committee is not convinced that tax credits are the only, or the most effective, vehicle to achieve this goal. Even in the case of R&D tax credits, we see this as an interim measure tied to performance and with a specific sunset timeframe involved. Tax incentives should not be a permanent solution.

As noted by the Institute for Research on Public Policy, other approaches need to be considered. "This policy stance (focusing on tax credits for R&D) is ineffective, too narrowly focused and even misguided. … Also, such single-minded effort to address the perceived shortfall in domestic research underestimates the importance of adopting the latest innovations regardless of their origin and the increasing role of international transfers of technology in enhancing Canadian productivity and growth."

In the limited time available for phase 1, the Committee was not able to explore other innovative approaches that could be used. This recommendation, therefore suggests that more work is needed to explore other, more innovative options on an ongoing basis.

As part of this ongoing review, the Committee also suggests that specific attention should be paid to ensuring that whatever tax credits or other incentive vehicles are put in place, those measures should ultimately provide a return to the province.

Concluding comments

As outlined at the outset of this report, the Committee views the phase 1 report and recommendations as an interim step to address specific issues related to the knowledge-based industries.

In the second phase, a number of related issues will be addressed, including changes to Alberta's personal tax system. This next step in the Committee's work will undoubtedly have an impact on Alberta's ability to attract and maintain a wide range of business and industry to the province, including the knowledge-based industry.

The Committee would like to thank all those who took the time to make presentations, write letters, and express their views as part of phase 1 of this review. We trust that the recommendations provided in this report will provide guidance to the provincial government in addressing the important issues identified by the knowledge-based industries.

Appendix

Selected Provincial Corporate Tax Incentives (as of April 27/98)

TAX INCENTIVES	BRITISH COLUMBIA	ALBERTA	SASKATCHEWAN	MANITOBA	ONTARIO
Labour Sponsored Venture Capital Corporations - Type A - supports an individuals' investment in broad-based investment funds	-Working Opportunity Fund provides a 15% provincial tax credit to a max. of $2,000 per year to a lifetime limit of $10,000. Matches federal credit.	none	-legislation exists although no fund has developed. -15% provincial tax credit on a maximum annual investment of $3,500. Matches federal credit.	-Crocus Investment Fund provides a 15% provincial tax credit on a maximum annual investment of $3,500. Matches federal credit.	-at least 13 funds exist providing a 15% provincial tax credit on a maximum annual investment of $3,500. Matches federal credit.
Labour Sponsored Venture Capital Corporations - Type B -employee share fund	-20% tax credit to a maximum of $2,000 a year.	none	-20% tax credit on a max. annual investment of $5,000	none	-20% provincial tax credit on the first $3500 and 30% on next $11,500 in the same year.
Equity Tax Credits	-30% tax credit to individuals on arm's length investments in a holding company investing in firms enhancing exports, replacing imports or diversifying.	none	none	none	none
R&D Tax Credits	none	none	-15% non-refundable tax credit for qualifying R&D expenditures.	-15% non-refundable tax credit on R&D expenditures carried out in Manitoba eligible for federal credit.	-R&D superallowance allows eligible R&D expenditures to be grossed up between 25 -52.5 %. -Ontario Innovation Tax credit also provides a 10% refundable tax credit to small Ontario firms for R&D done in the province. -100% write off on qualifying intellectual property -20% refundable tax credit for R&D contracted to approved post secondary and non-profit research institutions.
Manufacturing Investment Tax Incentives	none	none	-7% non-refundable tax credit on new and used manufacturing machinery, equip & buildings.	-10% non-refundable credit extended to June, 2000.	none
Education and Training Tax Credits	none	none	none	-refundable tax credit to students and their families.	-10% refundable credit to $1,000 on each student co-op work placement; leading edge tech. programs eligible in 1997. -10% refundable credit for hiring unemployed post-sec. graduates.

TAX INCENTIVES	QUEBEC	NEW BRUNSWICK	NOVA SCOTIA	PEI	NEWFOUNDLAND
Labour Sponsored Venture Capital Corporations - Type A - supports an individuals' investment in a broad-based fund	-FSTQ and the Fondaction provide a 15% provincial tax credit on a maximum individual annual investment of $3,500. Matches federal credit. - startups of new investment funds eligible for 50% refundable tax credit and for 5 year tax exemption on fund income.	-legislation exists but no provincial fund; one national fund provides a 15% provincial tax credit on a max. annual investment of $3,500. Matches federal credit.	-no legislation for provincial funds but a 15% provincial tax credit for two national funds on a maximum annual investment of $3,500. Matches federal credit.	none	none
LSVCC's- Type B - employee share funds	none	none	none	none	none
Equity Tax Credits	-Quebec Stock Savings Plan and Quebec Business Investment Corporations (SPEQs) provide tax credits on investments in eligible companies. - 50% deduction from income tax for investment companies on investments made after March 31, 1998.	-stock savings plan - an individual tax credit up to 30% of investment in shares of public companies operating in New Brunswick.	-an individual tax credit equivalent to 30% of an eligible investment in companies up to $30,000.	-rebates of up to 30% of an individual's equity investment in eligible companies.	-individual tax credit up to 30% of investment in shares of public companies operating in Nfld. -venture capital tax credit of 30% of equity investments.
R&D Tax Credits	-refundable tax credit of 20% of wages paid in Quebec for carrying out R&D, increased to 40% for smaller firms.	-a non-refundable credit of 10% of R&D expenditures made in the province.	-a refundable provincial tax credit of 15% of R&D expenditures made in the province.	none	- a refundable provincial tax credit of 15% of R&D expenditures made in the province.
Manufacturing Investment Tax Incentives	-125% immediate write off on new M&E, computer hardware and intangible technology transfer assets. -additional write-off of 15% on new assets for ore processing	none	-30% non-refundable credit on investment in manufacturing and processing until December, 2003. Can be carried forward for 7 yrs.	none	none
Education and Training Tax Credit	-refundable training tax credit of 40% for small firms and 20% for others. -wage subsidies to employers to hire student trainees. -40% refundable tax credit on wages of young, apprentice portfolio managers hired by International Financial Centres (IFCs). -23% non-refundable student loan interest tax credit.	none	none	none	none

TAX INCENTIVES	BRITISH COLUMBIA	ALBERTA	SASKATCHEWAN	MANITOBA	ONTARIO
Tax Holidays	-2 year corporate income tax holiday for eligible small businesses incorporated between May 1, 1996 and April 1, 2001. -2 year corporate capital tax holiday on eligible BC investment expenditures such as exploration, development and research.	none	none	none	none
Selected Sales Tax Exemptions (of significance to business)	-parts & materials for prototypes, livestock for human consumption, feed, seed, fertilizer, magnetite for ore processing, & certain exploration, drilling, energy conservation & safety equip. - software source code and "1-800" calls after May 1/98	no provincial sales tax.	-"direct agents" used in manufacturing and processing, 1-800 and 1-888 telephone services; farm machinery, repair parts, fertilizer, pesticides, and seed; natural gas and a variety of medical equip.	-certain "direct agents" used in manufacturing and processing, 1-800 telephone services, and on the sale of new homes to first time buyers. - custom software and computer program services.	-1-800 &-888 telephone services purchased by subscribers; some investment in production M&E, and customized computer equipment for R&D and mfg. or non-profit medical research activity.
Payroll Tax Exemption	none	none	none	-first $1.0 million exempted; phased-in exemption for next $1.0 million. -eliminated for international & interprov. trucking firms.	-phased in exemption on the first $200,000 of payroll in 1997 up to $400,000 in 1999.
Film and TV Tax Credits	-refundable credit of 20% of labour costs; bonus incentives of up to 3% of labour costs for entry level training, and up to 12.5 % of labour costs outside Vancouver area. -refundable credit of 12.5% of BC labour costs used by foreign productions.	none	-refundable credit of 35% of eligible labour costs; up to 40% in smaller centres.	-refundable credit of 35% of eligible labour costs.	-refundable credit of 20% of eligible labour costs(30% for eligible first-time prods). -refundable credit of 11% of Ontario labour costs used by foreign productions. --refundable credit of 20% on Computer Animation & Special FX labour costs.
General Capital Tax Exemptions		no general capital tax	-exemption of $10.0 million.	-exemption of $3.0 million.	-20-75% credit on eligible equity investments & 4% credit on direct loans in businesses by financial institutions (20% credit on investments in Community Small Business Investment Funds).
Other Major Tax Incentives For Business					

TAX INCENTIVES	QUEBEC	NEW BRUNSWICK	NOVA SCOTIA	PEI	NEWFOUNDLAND
Tax Holidays	-5 year holiday on income, capital & payroll taxes for new SME's carrying on business in an Information Technology Development Centre. -2 year capital tax holiday on new investment in mfg., computer hardware & bldgs. used for M&P or tourism. -new businesses with ≤$2 million in paid-up capital exempt from capital tax; exemption raised to $3 mil.July/99 -IFCs exempt from income, capital & payroll tax until 2009	none	-income tax rate of 0% for the first three fiscal periods on the first $200,000 of annual taxable income for eligible new businesses.	none	-10 year tax holiday from corporate income tax followed by a five year phase in for eligible business expansions and new startups.
Selected Sales Tax Exemptions (of significance to business)	-taxes on business inputs are rebated for small and medium size businesses.	-harmonized with GST. Taxes paid on business inputs fully rebated; university costs for R&D equipment rebated. -4% credit to $1500 on new home purchase or existing home renovation.	-harmonized with GST. Taxes paid on business inputs fully rebated.		-harmonized with GST. Taxes paid on business inputs fully rebated.
Payroll Tax Exemption	-tax rates for companies with payroll ≤$1 mil. reduced to 3.75% July 1/99 and 2.7% July 1/2000. -Companies with payrolls less than $5 million will also pay at a reduced rate.	none	none	none	-10 year tax holiday followed by five year phase-in for business expansions & startups.
Film and TV Tax Credits	-refundable credit of 33.3% of eligible labour costs. -refundable credit of 11% on Quebec labour for foreign productions. -refundable tax credit of 31% on Quebec computer animation and special FX labour for foreign productions.	-up to 40% of wages paid to New Brunswick residents.	-refundable credit for Nova Scotia film production companies of 30% of wages paid to Nova Scotians.		
General Capital Tax Exemptions	-exemption of $15.0 million over 5 years for new corporations. -exemption of $500 million in paid-up capital of banks. -Mining buildings used to process foreign ore eligible for two year deduction from capital tax.		-full rate only on firms with > $10.0 mil. in financial capital; phased in for firms with between $5 & $10 million; expires in 5 yrs.	no general capital tax.	no general capital tax.
Other Major Tax Incentives For Business	-refundable credits of 40% of wages up to $15,000 & the cost of specialized equip. & 2 yr. income tax exemption for foreign trainers working in firms in an Information Tech. Development Centre. -10 year tax freeze for major projects creating jobs		-non-refundable credit 35% up to $100,000 for firms seeking public share issue. -non-refundable tax credit of 25% up to $150,000 for firms seeking ISO certification.		

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